

## Research in Practice: Program for Financial Studies Newsletter

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### Does Unusual News Forecast Market Stress?

An increase in the "unusualness" of news with negative sentiment predicts an increase in stock market volatility. Similarly, unusual positive news forecasts lower volatility. Our analysis is based on more than 360,000 articles on 50 large financial companies published in 1996--2014.

Unusualness interacted with sentiment forecasts volatility -- at both the company-specific and aggregate level -- several months into the future. Furthermore, unusual news is reflected in volatility more slowly at the aggregate than at the company-specific level. News measures derived from articles explicitly about the "market" -- which are more easily accessible to investors -- do not forecast future volatility. (*Journal of Financial and Quantitative Analysis*, conditionally accepted)

Harry Mamaysky, Columbia Business School  
Paul Glasserman, Columbia Business School

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### How News and its Context Drive Risk and Returns Around the World

The development of a classification methodology for the context and content of news articles to predict risk and return in stock markets in 51 developed and emerging economies. A parsimonious summary of news, including topic-specific sentiment, frequency, and unusualness of word flow, predicts future country level returns, volatilities, and drawdowns. Economic and statistical significance are high and larger for year-ahead than monthly predictions. The effect of news measures on market outcomes differs by country type and over time. News stories about emerging markets contain more incremental information.

(*Journal of Financial Economics*, forthcoming)

Charles Calomiris, Columbia Business School  
Harry Mamaysky, Columbia Business School

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**The Market-Implied Probability of Government**



## Support for Distressed European Banks

Exploiting a 2014 change in credit default swap (CDS) contracts on European banks, an introduction of a measure of market expectation of European government support for distressed banks. CDS contract terms were changed to cover losses from “government intervention” and related bail-in events.

For many large European banks, subordinated CDS spreads are available under both the old and new contract terms; the difference (or basis) between the two spreads measures the market price of protection against losses from certain government actions that have mainly imposed losses on subordinated debt holders but left senior debt unscathed. Relative to the level of CDS spreads, the basis initially declined in 2014, a trend we associate with the adoption of European bank resolution reforms and bail-in requirements. This trend reversed in 2016, with growing prospects for bank bailouts in Italy. Even with an increase in the relative basis, CDS spreads signal a market perception that banks have insufficient subordinated debt to fully protect senior bondholders in case of default. (*Office of Financial Research*)

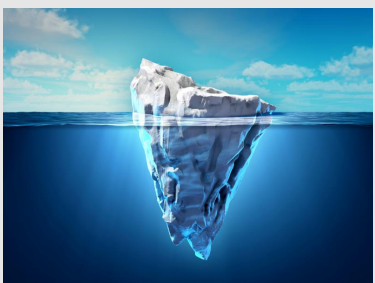
Paul Glasserman, Columbia Business School

Benjamin Kay, Federal Reserve

Richard Neuberg, Columbia University, Dept. of Statistics

Sriram Rajan, Office of Financial Research

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## The Economics of Rising Oceans

The projected rise in global average sea level, over the 21st century, has the potential to do immense economic harm, both in the US and around the world. We provide a non-technical review of the literature on the possible extent of sea level rise over the course of this century, and its economic consequences for the US. Sea level is likely to rise between two and fifteen feet, depending on the assumptions made about the progression of climate change and the method used to estimate sea level rise. The consequences for the value of coastal property and infrastructure will be immense, with losses in value of several trillion dollars in the worst-case scenarios and significant losses in even the most optimistic scenarios. (Working paper.)

Geoffrey Heal, Columbia Business School

Marco Tedesco, Columbia University

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## Do the FASB's Standards Add Shareholder Value?

Examining the cost-effectiveness, from the shareholders' perspective, of the accounting standards issued by the FASB during 1973–2009. Evaluation of (1) the stock market reactions of firms affected by the standards surrounding events that changed the standard's probability of issuance; and (2) whether the market reactions are related, in the cross-section, to agency problems, information asymmetry, proprietary costs, contracting costs, and changes in estimation risk.

The average standard is a non-event from the investors' perspective because 104 of the 138 standards examined are associated with no change in shareholder value. Nineteen (15) standards are associated with a decrease (increase) in shareholder value. Surprisingly, 25 standards are associated with an *increase* in estimation risk. In the cross-section, firms with higher levels of

information asymmetry, lower contracting costs, and a decrease in estimation risk experience most positive returns. (*The Accounting Review*)

Urooj Khan, Columbia Business School  
Bin Li, The University of Texas at Dallas  
Shivaram Rajgopal, Columbia Business School  
Mohan Venkatachalam, Duke University

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## The Expected Rate of Credit Losses on Bank's Loan Portfolios

Estimating expected credit losses on banks' portfolios is difficult. The issue has become of increasing interest to academics and regulators with the FASB and IASB issuing new regulations for loan impairment. We develop a measure of the one-year-ahead expected rate of credit losses (ExpectedRCL) that combines various measures of credit risk disclosed by banks. It uses cross-sectional analyses to obtain coefficients for estimating each period's measure of expected credit losses. ExpectedRCL substantially outperforms net charge-offs in predicting one-year-ahead realized credit losses and reflects nearly all the credit loss-related information in the charge-offs.

ExpectedRCL also contains incremental information about one-year-ahead realized credit losses relative to the allowance and provision for loan losses and the fair value of loans. It is a better predictor of the provision for loan losses than analyst provision forecasts and is incrementally useful beyond other credit risk metrics in predicting bank failure up to one year ahead. (*The Accounting Review*)

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